

## Murabahah Financing for a Small Medium Enterprise (SME)

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### ABSTRACT

*Murabahah is one of the most used financing modes in Islamic financial services. This case provides a detailed account of execution of murabahah financing for Small and Medium Enterprise (SME) dealing in general supplies. Murabahah is cost-plus sale, where the Islamic Bank purchased general supplies from Lahore and Karachi markets and sold the same to the Small and Medium Enterprise (SME) in Peshawar at a cost-plus price receivable to the Bank in six months. The management of the bank scrutinised the client's application for murabahah financing to mitigate different types of risk exposures such as late payments to suppliers in the past. In addition, a customised process flow was designed to ensure smooth flow of process in compliance with Shariah. The case reveals a pragmatic 42 steps long process of how murabahah implementation happens for SMEs in local market, which extend our understanding in terms of identifying micro processes that happened in the murabahah implementation, which are usually missed by the abstract theory on murabahah.*

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### Background

The case study focuses on local business, which was financing working capital through conventional modes previously, decided to explore Islamic mode of financing. The management of the SME was inclined toward Islamic banking in the past but due to lack of information, were unable to utilise suitable financing facilities through Islamic banking. The local business falls in general trader category of the Small and Medium Business (SME). The SME was partnership-based business, which after the retirement of owner as a sole proprietor, split in to half between two brothers. The SME is dealing in packed food items such as chips, cold drinks, confectioneries, and other general consumer goods.

Relationship Manager (RM) of Islamic bank is primary dealing with corporate clients such as SMEs and large corporations and advises these institutions on various banking and financial products and services offered by the bank. A RM from a local Islamic banking branch in Peshawar, Pakistan though chamber of commerce identified an SME dealing in food related business. In the first meeting with the company, the RM was informed that their finished products are acquired from different suppliers in Karachi and Lahore, two other big cities in Pakistan, and they have proper storing facilities in Peshawar. These foods related supplies are sold to local retailers in Peshawar. Their order mechanism from the suppliers in Karachi and Lahore was based on already places orders from retailers in Peshawar. The company fell in

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high inventory turnover and quick cash conversion cycle, an ideal company for the bank as a potential client. In the first meeting with RM, partners also showed keen interest in financing their purchases through Islamic banks. The RM briefed the partners about the concept of Islamic banking in practice and different financial contracts in general and murabahah financing in specifics can be utilised to offer the solution to the need of client.

The company was already financing their working capital purchases through conventional modes but was not happy with the interest factor. After the first meeting with both partners, the RM invited them to the bank to meet with branch and area managers of the bank to discuss further the details of services bank can offer to support their business activities.

After discussion with both partners, it was agreed to finance their purchases through murabahah financing, where bank, will buy the good from already identified suppliers in Lahore and Karachi, and sell to the SME on agreed profit margin at the known cost of goods. In this transaction, no cash will be provided to the SME by the Islamic bank. In the end of meeting, RM provided a list of documents to be submitted by the company to proceed further for murabahah based financing.

#### **Documentation of the Murabahah financing**

The general manager of the company arranged and provided attested photocopies of partnership deed and Form H from the registrar office. Other documents provided to the RM of the bank were list of potential retailers in the city to whom the SME supplies the goods, financial statements of the business, sanctioned letter for already arranged loans, and property documents to be used as a mortgage for the murabahah facility. The SME offered two houses situated in a residential area of the city for the mortgage. However, the houses were on the name of the SME partners' mother and other on the father's name.

RM of the bank, after receiving all the required documents, started preparing the murabahah proposal for the business. In addition, RM requested legal advisor team of the bank to assess the property documents of the client. The RM also forwarded the documents to the bank's assigned valuation officer to prepare the valuation report of the property to be mortgaged. The valuation report of the property helped the bank to assign the limit of the murabahah to the client. It is prudential regulation that the financing limit should not be above 60 percent of the total value of the property mortgaged.

The RM forwarded the company's detailed documents to the regional coordinator of the bank for Credit Information Report from the credit information bureau of State Bank of Pakistan (SBP) and provided the same to the RM. The business had no default in the past and had clear report.

RM also prepared market trend analysis report of the business, which included the history of the company, profile of the retailers, feedback from the supplier, and competitors' analysis. These reports were part of the SWOT analysis, which were provided to the head office for the approval of murabahah financing facility for the SMEs.

### **Murabahah Proposal, Risk Management Practices, and Approval Process**

Once the murabahah proposal was prepared, it was forwarded to branch manager and area manager to review. Once review, it was forwarded to regional office for review and approval. Each level of office has an authority to approve certain limit of financing, for example, branch manager can approve a limit up to 2.5 million, whereas area manager can approve a financing up to 5 million and regional manager has the authority to approve financing up to 10 million, which is also the approved limit of SMEs. Whereas, the head office approves anything above this limit.

The regional coordinator, however, raised multiple queries from risk perspective. One query was on the stocks theft and protection facilities, since these stocks were very small items and very bulky in nature. RM discussed the observation raised with the owners of the SME. The owners informed the RM that storage facility of the firm had fire extinguishers installed there as well as a regular security guard on duty with double shifts. The owners also provided the map of the facility showing the anti-theft measurements by the firm.

The second query raised by the regional coordinator was about the business regular reliance on another bank for financing and whether the business had enough liquidity to pay murabahah instalment to the Islamic bank at the same time. The owners proposed to start utilising Islamic bank facility, only once transaction on early loans settle off with the existing bank. The business once settled their loans facility with existing bank, requested RM for new Customer Information Report. The new report showed that past dues were settled with other banks.

### **Shariah Compliance and Process Flow Design**

The Product Development and Shariah Compliance (PDSC) department, irrespective of the limit of the facility, must design the process flow of the service; therefore, the proposal was forwarded to the head office. The PDSC department customised the murabahah financing process flow structure for this specific case as it is done for all new cases. This step is an important Shariah compliance check and must be followed whenever there is any modification to the murabahah financing process flow. The PDSC sent the customised process flow design back to regional coordinator to confirm whether the customer agree with the proposed design flow of the service. The customisation process includes specifications of parties involved and subject goods of the sale transaction. For example, in this case, payment should be made to the supplier, and the stock should be kept separate from existing stock. This will help the bank to identify the stock they are trading as necessary for the transaction.

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### **Post Sanction Formalities**

RM, along with credit department and clients after fulfilling the post-sanctioned formalities from the PDSC which also included, preparing formal mortgage contract at registrar office and personal guarantees of the partners of the business, requested one of the panel Takaful companies to cover the mortgaged properties and stock of the company. Takaful is applied as the risks attached to the location and goods are to be covered through the blanket murabahah Takaful. Once mortgage documents, takaful and other small legal documents were completed, Master Murabahah Finance Agreement (MMFA) was signed by the SME and bank. In MMFA, the bank offered to sell the required stock to the SME at a mutually agreed cost plus profit price, whereas the SME accepted the offer to buy the stock. In addition, the bank signed an agency agreement with the client to appoint the later as an agent to purchase the stock from the approved list of suppliers on behalf of the bank, whenever there is a need to buy the stock.

### **Execution of the Murabahah contract: The Bank, Client and Suppliers**

The purchase manager of the company from the approved list of suppliers requested the banks to order the stock from Lahore. The bank appointed the SME as an agent and requested quotation of stock needed. After receiving the quotation, the bank prepared the draft as per quotation and requested supplier through agent to deliver the stock to the storage facility of the SME. The supplier issued the invoice to the bank as the purchaser of the stock, delivered to the SME as an agent of the bank.

After 4 days, the SME informed the bank about arrival of goods at the site office. The RM visited the site, and inspected the stock. This process also assures the ownership risk born by the bank before the raw material is offered to the SME for sale through murabahah financing. The client offered to purchase the stock from the bank through a declaration and the bank accepted to sell the stock on the spot as per agreed cost-plus mark-up. The murabahah facility extended to the client was of 6-month duration, based on KIBOR plus spread, which varies from client to client. The KIBOR at the time of sale was 12 percent with 2.5 percent of spread. A week before the due date a letter was sent to the client that murabahah is to be matured in next week to make the payment. The customer paid the due amount at the end of sixth month by depositing a cheque with the Bank and completed the murabahah financing facility. The mortgage and personal guarantees are withdrawn. The overall process of Murabahah with SEM is portrayed in figure 1:



Figure 1: Murabaha implementation process

**Teaching Notes:****Objectives:**

This case is developed to make the undergraduate students:

- Understand the concept and process of Murabahah implementation
- Comprehend the context of murabahah, when it used as financing mode for working capital of an SME

**Methodology of the Case Development:**

The case study followed a narrative based qualitative research. The information about the execution of the murabahah contract was gathered through in-depth interview with the RM of the bank. Published archived material was also used to provide different aspects of murabahah financing.

**Suitability of case:**

This case will be suitable for the following purpose.

- Undergraduate and graduate students studying Islamic banking and finance course.
- Students who are learning Islamic modes of financing.
- Trainees interested in the learning of working capital finance being practiced in SME's in Pakistan.

**Assignment Questions:**

1. Identify and discuss the process flow and the documentation process of the murabahah case. Does the process was followed properly in this case?
2. How the process of risk assessment took place in the case? Do you think the process was followed accordingly?
3. Does the process was compliance with the Shariah guidelines of the murabahah contract?
4. Identify and discuss the services, which are necessary for implementation of murabahah service.
5. Identify the risk associated with the contract on different levels of the transaction.

**Reading Suggested**

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